

WRITTEN STATEMENT OF
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CONCERNING CONFLICTS OF INTEREST FACED BY BROKERAGE FIRMS
AND THEIR RESEARCH ANALYSTS
BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES
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Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee:

I am pleased to testify today on behalf of the Securities and Exchange Commission (“Commission”) as you consider the issues surrounding conflicts of interest faced by brokerage firms and their analysts.

Financial analysts exert considerable influence in today’s marketplace. The increased popularity of investing in stocks coupled with the media’s intense focus on recommendations has dramatically raised the public profile of analysts. Recently, however, public scrutiny has shifted towards examining the conflicts of interest that may affect analysts’ recommendations. Congress¹ and the Commission² have shone a

¹ On June 14, 2001, the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the House Financial Services Committee held a hearing entitled, “Analyzing the Analysts: Are Investors Getting Unbiased Research From Wall Street?”

² See Remarks by Acting Chairman Laura S. Unger at the Ray Garrett Jr. Corporate and Securities Law Institute, Northwestern University School of Law, “*How Can Analysts Maintain Their Independence?*” (April 19, 2001).

spotlight on this issue, while almost countless press reports³ have provided further accounts of the numerous conflicts affecting brokerage firms and their research analysts.

As I noted in a recent speech, there is a mood of skepticism about analysts' stock recommendations. This skepticism is due, in large part, to a blurring of the lines between research and investment banking. For example, analysts' compensation is increasingly becoming tied to the investment banking business they generate. Moreover, analysts often own shares -- including those obtained before initial public offerings ("IPOs") -- in the companies they follow and recommend. Analysts at times issue "booster-shot" research reports close to the expiration of lock-up periods.⁴ In addition, some firms have structures where analysts report, at least indirectly, to the investment banking unit.

I recently called on the industry to take an active role in dealing with these and other problems surrounding analysts' conflicts of interest. It is fair to say, as I will fully describe in my testimony here today, that the industry, as well as the self-regulatory organizations ("SROs") have heard this call to action.

Today I will discuss: (1) the myriad sources of conflicts of interest that threaten the objectivity of analyst recommendations; (2) preliminary observations from a recent series of on-site examinations by SEC staff concerning current practices in the industry; and (3) recent initiatives in this area to cure the problem.

³ See e.g. Justin Schack, "Should Analysts Own Stock in Companies They Cover," INSTITUTIONAL INVESTOR, (April 1, 2001); and Charles Gasparino, Deals & Deal Makers: "Outlook for Analysts: Skepticism and Blame," WALL ST. J., Jun 13, 2001, at C1.

⁴ Underwriters typically obtain lock-up agreements from the issuer's private equity holders not to sell their securities into the public marketplace for a specified time after an IPO, typically 6 to 12 months. These lock-ups are designed to prevent disruption of the new market for the securities by the immediate introduction of private placement stock into the public marketplace.

SOURCES OF CONFLICTS OF INTEREST

It has become clear that research analysts are subject to several influences that may affect the integrity and the quality of their analysis and recommendations.

There are numerous pressures that exist within full-service brokerage firms, but four potential areas of conflict stand out. They are as follows:

- (1) Attracting and Retaining Clients: The analyst's firm may have underwritten an offering for a company or seek to underwrite a future offering. The analyst may have been a part of the investment banking team that took the company public.
- (2) Firm Profits: Positive reports by brokerage firm analysts can also trigger higher trading volumes, resulting in greater commissions for the firms.
- (3) Compensation: An analyst's salary and bonus may be linked to the profitability of the firm's investment banking business.
- (4) Equity Stakes: The analyst, other employees, and the firm itself may own significant positions in the companies the analyst covers. Analysts may participate in employee stock purchase pools that invest in companies they cover or they may own stock directly. And, in a recent trend called "venture investing," firms and analysts may acquire a stake in a start-up company by obtaining discounted, pre-IPO shares.

CURRENT INDUSTRY PRACTICES

Existing rules of the SROs require broker-dealers to disclose whether they make a market in the recommended security and whether they have recently underwritten a public offering in the company's securities. In addition, the National Association of Securities Dealers ("NASD") requires that the firm, and/or its officers or partners (but not

the covering analyst) disclose ownership interests in the company's options, rights and warrants (but not common stock). The New York Stock Exchange ("NYSE") requires the firm and the covering analyst to disclose whether they "may" have an ownership interest in the company's securities (including both options and common stock).⁵

SEC staff has conducted on-site examinations of full-service broker-dealers focusing on analysts' conflicts of interests. The staff has reviewed firms' written disclosures. It also selected for examination nine firms that underwrote significant numbers of IPOs, particularly Internet and technology-related IPOs.⁶ The staff reviewed documentation and interviewed senior management of firms' research and investment banking departments and research analysts. These examinations focused on analysts' financial interests in companies they cover, reporting structures, and compensation arrangements.

While these examinations are ongoing, I will share with you some of our staff's preliminary observations:

- *Research analysts provided significant assistance to investment bankers.*

All firms examined reported that research analysts were not formally supervised by investment bankers, but all firms reported that research analysts provided assistance to investment banking, such as consulting on possible mergers, acquisitions and corporate finance deals, participating in road shows and initiating research coverage on prospective investment banking clients. Many firms pay their analysts largely

⁵ The NYSE also requires the firm to disclose if any employees of the firm are directors of the company covered by the research report.

⁶ These firms include eight of the top 12 underwriters in terms of the number of new issues underwritten in 2000, based on data available on the EDGAR system.

based upon the profitability of their investment banking unit, and investment bankers at some firms are involved in evaluating the firm's research analysts to determine their compensation.⁷ Seven firms reported that investment banking had input into research analysts' bonuses.

- *Many research analysts were significantly involved with start-up companies well before the companies had established an investment banking relationship with a broker-dealer.*

This involvement typically included establishing an initial relationship with the company, reviewing the company's operations, and providing informal strategic advice. Many times, these analysts were invited to invest in these companies' private placements, which were not available to the public generally. The staff also found that if the company went public and the analyst's firm underwrote the IPO, the analyst always issued positive research on the company.

- *It is commonplace for research analysts to provide research reports on companies that the analysts' employer firms underwrite.*

In 308 of 317 IPOs examined, for example, the firm that underwrote the security also provided research coverage.

- *Analysts sometimes provide investment bankers with prior notice of changes in recommendations.*

Six firms stated that at times analysts provide investment bankers and client management with advance notice of a pending change in the analyst's

⁷ At one firm, the head of investment banking set the aggregate bonus pool for the research department and exercised discretion over individual analysts' bonuses. At another firm, some senior analysts have contracts that provide for them to receive bonuses based on the amount of investment banking revenue generated by the business sectors the analysts cover.

recommendations. None of the firms reported that investment bankers had authority to stop an analyst from downgrading a particular company's rating.

- *Some research analysts own securities in companies they cover.*

These analysts sometimes acquired their shares in private placements prior to the initial public offering for a fraction of the IPO price. The staff found that 16 of 57 analysts reviewed had made pre-IPO investments in a company they later covered. Subsequently, the analysts' firms took the company public and the analyst initiated research coverage with a "buy" recommendation. Examiners found that three of these analysts executed trades for their personal accounts that were contrary to their recommendations in their research reports.⁸

- *Existing regulations do not prohibit analysts from owning stock in companies the analysts cover, but some firms' policies do.*

Other firms permit analysts to own stock in companies they cover but forbid them from executing personal trades that are contrary to the analysts' outstanding recommendations.

- *At the firms examined, compliance with SRO rules that require firms to monitor the private equity investments of employees (including analysts) was found to be poor.*

Nearly all firms examined were unable to identify accurately all private equity investments by their employees in companies the firms took public. Consequently, firms did not always know whether their research analysts owned stock in companies they underwrote and upon which their analysts then issued research reports.

⁸ These analysts generated profits of between \$100,000 and \$3.5 million by selling their shares while continuing to maintain a "buy" recommendation. One analyst sold securities "short" while maintaining a buy recommendation on the subject company.

- *Disclosure of analysts' and firms' ownership in recommended securities varies widely.*

Some firms' analysts' reports affirmatively state that they or their employees hold positions in recommended securities (very few firms provide actual percentages of ownership), while other firms use boilerplate noting, "the firm or employees *may* have positions in the recommended issuer." The staff found some instances in which the analysts' ownership in stock of the covered company was not disclosed in the research report at all.

- *Disclosure in analysts' reports of whether the firm has an investment banking or other relationship with the company covered is limited to disclosure of whether the firm has recently acted as underwriter or market maker, as required by existing SRO rules.*

Most firms disclose whether they have recently underwritten a public offering or act as a market maker, as required by existing SRO rules. Some firms affirmatively state that they have acted as an underwriter or a market maker; other firms state only that they "may" have acted as an underwriter or "may" make markets in the security.

- *Sell-side analysts routinely recommend securities during public appearances in the media (such as on financial television and radio programs), but rarely reveal any conflicts of interest to investors.*

SRO rules require that analysts reveal conflicts. The obligation to disclose conflicts of interest is not dependent on the communication medium used -- it is the same

whether the recommendation is made in a written research report, on television,⁹ or via an electronic communication.¹⁰

- *Examiners found indications that some research analysts issued “booster-shot” research reports.*

These reports reiterated “buy” recommendations shortly before, or just after, the lock-up period expired. The staff reviewed the lock-ups of 97 companies in which the firm that underwrote the IPO, or an analyst employed by that firm, owned stock in the company. In 26 of these instances, the analyst issued a “buy recommendation” within a week of the expiration of the lock-up period. “Booster shot” reports may generate buying interest in the stock and help increase the stock price while the firm, the firm’s clients, or the analysts sell their shares.

- *Analysts’ rating terminology may be unclear to investors.*

Full-service broker-dealers use a variety of undefined terms to describe their investment recommendations, including: “buy,” “sell,” “strong buy,” “hold,” “neutral,” “accumulate,” “near-term accumulate,” “long-term buy,” “outperform,” “market perform,” and “market under-perform.” The wide variety of terms may confuse investors.

RECENT DEVELOPMENTS

The industry, the SROs, and the Commission have recently taken action to improve the objectivity and independence of research analysis.

⁹ See, e.g., *Brill’s Content*, “Financial Analysts Are Recommending Stocks on Television Without Revealing Their Firms Have Ties to Some of the Companies Involved” (April 2000), which chronicled analysts’ failure to divulge conflicts of interest during public appearances.

¹⁰ Despite the language of its rule, the NASD has stated that it does not interpret the disclosure requirement to apply to media appearances by analysts. The NYSE has stated that its disclosure obligation does apply to media appearances.

1. *Industry Initiatives*

a. SIA Best Practices

The Securities Industry Association (“SIA”) recently set forth “Best Practices for Research,” which establish useful guidelines for brokerage firms and their analysts in addressing situations that can give rise to analyst conflicts that impair the value of their research for investors. The SIA importantly notes that the investor, not the firm or the analyst, is the intended beneficiary of research. The more significant practices recommended by the SIA include: prohibiting analysts’ compensation from being based on fees obtained in specific investment banking transactions; shoring up analysts’ independence by not having them report to investment banking personnel; disclosure of analysts’ ownership positions in securities they cover; and a general prohibition on analysts trading against their recommendations.

b. AIMR Issues Paper

The Association for Investment Management and Research (“AIMR”) recently circulated to its members for comment a proposed issues paper, “Preserving the Integrity of Research,” that identifies and discusses certain conflicts of interest and pressures experienced by analysts working for full-service brokerage firms that may bias their reports and recommendations. AIMR’s paper calls for a separate reporting structure for personnel within the research and investment banking departments, thus preventing bankers from influencing analyst recommendations. AIMR also disavows compensation arrangements that directly link analyst remuneration to investment banking assignments. The paper also discusses external pressures that public companies and institutional clients sometimes exert on analysts and discourages retaliatory practices.

c. Firm Initiatives

Securities firms are revising their existing policies and procedures to manage conflicts. For instance, at least three securities firms have recently adopted policies prohibiting analysts from owning securities in companies they cover in research.¹¹

2. *SRO Rule Changes*

There are gaps and inconsistencies between NYSE and NASD rules governing disclosure of analyst conflicts.¹² The NASD requires that its member firms (but not individual analysts) affirmatively disclose certain proprietary holdings (options, rights, and warrants but surprisingly not common stock). The NYSE permits a generic disclaimer.

The NASD recently proposed for member comment changes to its conflict disclosure rule that would fill certain gaps and address inconsistencies in their rule.¹³ The NASD's proposal would extend the obligation to disclose conflicts of interest to individual analysts of NASD member firms and cover common share ownership. The amendments would also require abbreviated disclosures during public appearances

¹¹ See "Credit Suisse Limits Holdings Of Its Analysts" WALL ST. J., July 25, 2001, at C14; "Edward D. Jones Puts Limits on Stock Owned by Analysts" WALL ST. J., July 12, 2001, at C13; and "Merrill Alters a Policy on Analysts" WALL ST. J., July 11, 2001, at C2.

¹² *NASD Rule 2210* requires disclosure that the firm "and/or its officers or partners own options, rights or warrants to purchase any of the securities of the issuer whose securities are recommended, unless the extent of such ownership is nominal." The NASD rule does not mandate the disclosure of common share ownership of a recommended issuer, nor does it require that the analyst who prepared a research report disclose ownership of any financial interest in a recommended issuer. *NYSE Rule 472* covers all financial positions (including common shares) held by a firm and a covering analyst, but permits the use of generic disclosure language such as "... the firm or employees may own securities or options of the issuer recommended in this report." Neither rule requires disclosure of the size of the financial interest.

¹³ On July 2, 2001, the NASD issued a Notice to Members (NTM 01-45) that proposes amendments to its disclosure rule that, among other things, would include common stock as a financial interest that must be disclosed and would require financial interest disclosures by analysts as well as firms.

(television, radio, *etc.*), and that disclosures in written reports be “specific” and “prominent.” The NASD’s proposal asks questions about some important details, such as whether disclosure of stock ownership should be required only at a minimum level such as 5%, and whether disclosure of firm relationships with a company should be broadened in scope but apply to a shorter timeframe. The NYSE is also reportedly considering amendments to strengthen its conflict disclosure rule.

3. *Commission Initiatives*

The Commission plans to work with the SROs to improve and more diligently enforce their existing rules governing the disclosure of conflicts of interest.

In addition to Commission examinations, the Commission’s Office of Investor Education and Assistance (“OIEA”) issued an Investor Alert last month, explaining to investors exactly what conflicts analysts might face and how investors should interpret disclosures about these conflicts.¹⁴

The Alert explains the relationships between securities analysts and the investment banking and brokerage firms that employ them and educates investors about potential conflicts of interest analysts may face. In particular, the Alert notes, some analysts work for firms that underwrite - - or even own - - the securities of the companies the analysts cover. And in other cases, analysts themselves might own stocks in the companies they cover - - either directly or indirectly through employee stock-purchase pools in which they and their colleagues participate. Some firms link an analyst’s annual salary and bonuses to the profitability of the firms’ investment banking business.

¹⁴ OIEA’s alert is entitled: “*Analyzing Analyst Recommendations*,” available on the Commission’s web site at www.sec.gov/investor/pubs/analysts.htm.

The Alert urges investors not to rely solely on analyst recommendations when deciding to buy, hold, or sell stock. Instead, investors should consult multiple sources of information, such as the company's financial filings, while considering their own investment goals and tolerance for risk. The Alert also provides tips to help investors find out whether an analyst or the analyst's firm has a financial interest in a company's securities.

SOME CONFLICTS MAY ALWAYS EXIST

We encourage further consideration by the industry and the SROs to minimize and manage conflicts of interest. At the same time, we recognize that some conflicts may always exist.¹⁵ At a minimum, the Commission should continue to promote both clear, meaningful, and prominent disclosure, as well as effective investor education, so that investors may weigh for themselves the significance of any conflicts.

The role of investor education is particularly important because there are other pressures originating outside the firms that may affect research analysis and recommendations. Since these pressures are largely outside the control of the firm, arguably they are more difficult for the firm to address. These pressures include:

- (1) Pressure from institutional investors: Institutional investors, such as mutual funds, that are clients of the analyst's firm may have a significant position in the security of a company covered by an analyst. An analyst may be inhibited from issuing a rating downgrade that would adversely affect the performance of an

¹⁵ It should be noted that there may be benefits from research analysts working with investment bankers. For example, an investment banker underwriting a company's offering will sometimes employ its firm's research analysts to help it conduct its due diligence investigation into the company it is underwriting. The due diligence investigation helps ensure that the prospectus contains all material information required to be disclosed. In these cases, research analysts can play an important role in facilitating the due diligence process, especially in expedited offerings.

institutional client's portfolio for fear that the client would take its brokerage business elsewhere. Moreover, many publications rate analysts based upon input from institutional investors.

- (2) Pressure from issuers: The management of companies an analyst follows may pressure him/her to issue favorable reports and recommendations. Less than favorable recommendations may not be well received by management and issuers may threaten to cut off an analyst's access to its management if the analyst issues a negative report on the company. This could cause the analyst to issue a more favorable report than his/her analysis would suggest.

CONCLUSION

Analyst practices are now firmly in the spotlight. That spotlight has exposed the conflicts analysts face. This exposure is beneficial for investors. Analysts and their employer firms should carefully consider their policies and procedures regarding research and, when possible, minimize conflicts of interest that might bias their research and recommendations. Where actual and potential conflicts do exist, they should be clearly and meaningfully disclosed to investors.

I am hopeful the recent industry initiatives will help to reduce or more effectively manage the conflicts that threaten analysts' fairness and objectivity. I am also optimistic that appropriate amendments to SRO rules, coupled with vigilant enforcement of these rules, will improve disclosure of conflicts of interest by firms and their analysts. We will closely monitor these developments. We also look forward to working with the Subcommittee as we move forward.

Thank you.